

LBJ LIBRARY
Mandatory Review
Case # NLJ 98-380
Document # 6

~~Secret~~

Copy #19 To Lewis



DIRECTORATE OF
INTELLIGENCE

APPROVED FOR RELEASE
DATE: MAY 2001

Intelligence Memorandum

Uruguay's Continuing Economic Impasse.

~~Secret~~

ER IM 68-133
October 1968

Copy No. **13**

~~WARNING~~

~~This document contains information affecting the national defense of the United States, within the meaning of Title 18, sections 793 and 794, of the US Code, as amended. Its transmission or revelation of its contents to or receipt by an unauthorized person is prohibited by law.~~

~~GROUP 1
Excluded from automatic
downgrading and
declassification~~

~~SECRET~~

CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
October 1968

INTELLIGENCE MEMORANDUM

Uruguay's Continuing Economic Impasse

Summary

During the past 12 years, Uruguay has slipped from first to third place in Latin America in per capita output and has been the only reasonably well-developed country in the world to suffer a pronounced decline in per capita output. Gross national product and private consumption are both about 15 percent lower on a per capita basis than in 1955, and investment has dropped to the point that it no longer covers replacement needs in some areas. One out of every five persons in the labor force is without work. Inflation has grown worse each year, reaching an annual rate of 169 percent during the first half of 1968. Partly as a consequence of the prolonged economic decay, Uruguay increasingly has experienced civil disorders.

The root of Uruguay's inflationary problem has been the attempt by the highly organized urban labor force and the business community to protect their economic positions in the face of a decline in the per capita supply of goods. Wages and prices have chased each other with increasing speed, the race being fueled mainly by an unrestricted expansion of credit to the private sector. Especially in recent years, the government has added to the inflation by enlarging public payrolls and financing the resulting budget deficits with bank credits. Inflation and the necessity to periodically devalue the currency have provoked a

Note: This memorandum was produced solely by CIA. It was prepared by the Office of Economic Research and was coordinated with the Office of National Estimates and the Office of Current Intelligence.

~~SECRET~~

~~SECRET~~

flight of capital, some of which appears to be lost permanently. The loss of capital, the reduction in imports, the diversion of public funds to current expenditures, and growing uncertainty regarding future prices and costs are mainly responsible for the decline in investment. Uruguay's inflation differs greatly from that in Brazil, Chile, and most other Latin American countries, where the government finances much of investment and its budget deficit is the principal source of monetary expansion.

The administration of President Pacheco Areco, who assumed office on the death of President Gestido in 1967, has begun to grapple with economic problems much more forthrightly than any administration in the last decade. Recent economic policy has been guided by the financial stabilization plan that the Gestido government introduced simultaneously with a 50-percent devaluation of the peso in November 1967. The plan called for a reduction in the rate of inflation and a \$30 million rise in foreign exchange reserves. These goals were to be reached by drastically reducing the budget deficit, stringently controlling private credit, maintaining a more realistic exchange rate, and directly regulating increases in most wages and prices.

Through mid-1968, foreign exchange reserves rose modestly, owing to a rollover of debts to foreign banks and a severe reduction in imports. On the other hand, the inflationary effects of devaluation, unfavorable crop conditions, and strike pressure from labor led to higher than planned wage settlements in the public sector and an acceleration of price increases during the first six months of 1968.

Threatened financial chaos, near-paralysis of basic economic and social services, and increased agitation by the Communist-led students and labor unions and by terrorist groups caused President Pacheco Areco to impose a limited state of siege in early June. Later in the month the administration took unprecedentedly strong actions in an effort to curtail labor and student agitation. The administration also decreed a price and wage freeze, which stabilized prices in July and August.

~~SECRET~~

~~SECRET~~

In the coming months the government will be walking a tightrope. It will have to maintain tight controls to begin laying the foundations for economic recovery but in so doing will also be risking a serious disruption of output. Disruption could result from too much anti-inflationary medicine or from widespread public disorders in reaction to stabilization policies. The alternative to tight controls could be even worse, however. If public discontent forces the government to relax its controls, runaway inflation and a consequent breakdown of normal market activities might develop. Under the best circumstances, constraints on imports, a degree of austerity in government expenditure, and the expected decline in livestock output probably will hold total output in the next year at the depressed level of 1967-68.

For progress over the longer term, the Uruguayan government must introduce basic reforms conducive to an expansion of exports and investment. Paramount in such reforms would be a shift in economic policy from support of urban consumption to an emphasis on agricultural investment (both public and private) and a continuing firm effort to subdue inflation. Such a program would be vigorously opposed by the well-organized labor movement and business interests. Even the population at large would be difficult to convince that, after 12 years of eroding living standards, an extended period of government-fostered austerity was in their interest. Thus thoroughgoing reform and rejuvenation of the economy probably can be accomplished only by a government that is willing and able to thwart the popular will.

~~SECRET~~

Introduction

1. Almost daily since the spring of 1968, Uruguay has experienced unusually severe civil disorders. The agitation has included frequent general strikes and street rioting and the kidnaping of a personal adviser to President Pacheco Areco, who assumed office in December 1967 upon the death of President Gestido. While this disarray partly reflects the growing organizational competence of Uruguay's leftists, it indicates more fundamentally the social and political consequences of longstanding economic decay. The disorder raises anew the questions, among others, of what is wrong with the Uruguayan economy and where it is heading.

A Case of Arrested Economic Development

2. Uruguay is the only relatively developed, modern country that has failed to advance economically over the past dozen years. Following a half-century of progressive leadership, the Uruguayans by the mid-1950's had erected an efficient economic system based on exploitation of rich livestock resources. Recent estimates indicate that Uruguayan gross national product (GNP) per capita in 1955 was the highest in Latin America and compared favorably with that in many European countries, being one-fourth higher, for example, than that in Italy.* Moreover, Uruguay had a reasonably equitable distribution of income.

3. Since 1955, however, the Uruguayan economy has been in a torpor matched in Latin America only by that of Haiti. The total output of the economy, as measured by GNP in constant prices, has not grown significantly since 1955. Per capita GNP in

* The estimates consist of purchasing power parity calculations by staff members of the UN Economic Commission for Latin America, as published in Stanley N. Braithwaite, "Real Income Levels in Latin America," Review of Income and Wealth, June 1968, pp. 113-182. For the present purpose, the geometric means of results obtained with US and Latin American quantity weights are used. These estimates are for gross domestic product, which in Uruguay normally varies only slightly from GNP.

~~SECRET~~

1967 thus was about 15 percent less than that of 1955. Activity in all sectors except crops picked up during 1964-66. But in 1967, unfavorable weather caused a decline of one-sixth in agricultural output; production in manufacturing, construction, and basic services fell about 4 percent in the aggregate; and GNP fell by an estimated 5 percent. No sector has made substantial progress during the past 12 years (see Table 1).

Table 1

Uruguay. Indexes of Production, by Sector of Origin
Selected Years, 1955-67

	1955 = 100				
	<u>1955</u>	<u>1960</u>	<u>1963</u>	<u>1966</u>	<u>1967 a/</u>
Gross national product	100	100	99	107	102
Agriculture	100	87	102	104	86
Crops	100	45	82	82	N.A.
Stock farming	100	108	111	115	N.A.
Manufacturing	100	105	101	110	N.A.
Construction	100	101	69	82	N.A.
Basic services <u>b/</u>	100	106	103	116	N.A.
Wholesale and retail trade	100	92	89	101	N.A.
Other services <u>c/</u>	100	106	107	112	N.A.

a. Provisional.

b. Electric power, transportation, and communications.

c. Public administration, personal services, banking, and real estate.

4. Investment has been hit especially hard over the last dozen years as Uruguayan governments succeeded in boosting public consumption (that is, current government expenditures excluding subsidies and

transfer payments) while generally maintaining the level of private consumption (see Figure 1). Although GNP in 1967 is estimated to have been slightly larger than in 1955, gross fixed investment in 1967 is estimated to have been only about 55 percent of the 1955 level. The share of fixed investment in GNP was only about 12 percent in 1965 and 10 percent in 1966 and 1967. Uruguay's overall stock of fixed capital probably has increased a little in the last three years,* but there may have been net disinvestment in machinery and equipment. The volume of construction declined consistently from 1955 through 1963, when it was less than one-fourth of total investment. During 1964-67, construction activity partly recovered because of a diversion of funds from industry to tourist facilities and other commercial construction by investors hedging against inflation. At the same time, investment in machinery and equipment dropped from about 10 percent of GNP to 5 percent.

5. The impact of economic troubles on the private consumption expenditure of Uruguay's 3 million people has been less severe than that on investment. The Uruguayans have managed to maintain total private consumption at about three-fourths of GNP each year since 1955. This accomplishment nevertheless implies a 15-percent reduction in per capita consumption during 1956-67.** Rural inhabitants (who presently account for less than one-fifth of the population) and the young entrants into the labor force generally have borne the brunt of the squeeze on private consumption. Farm incomes have been held down by low world market prices for Uruguay's agricultural exports, by discriminatory tax policy, and by lags in the adjustment of exchange rates to reflect increases in farm costs. Unemployment, which has increased steadily since the mid-

* There are no recent data on depreciation of capital, but figures for the late 1950's and early 1960's range around 7 percent of GNP.

** The data on consumption should be understood only as rough estimates. Although collectors of Uruguayan statistics impute values for contraband trade with Brazil and Argentina, their national accounts estimates may somewhat understate these flows, particularly of the consumer goods illegally imported into Uruguay.

1950's, is estimated to have exceeded 20 percent of the labor force in 1967. The young make up a large share of the unemployed, in part because the labor force is highly organized and union leadership has been concerned primarily with insuring job security and wage increases for its membership, not with bringing new wage earners into its ranks. Although urban families with regular wage earners have been better able to protect their standard of living, they also have suffered a decline in consumption levels.

6. Despite the decline in output per capita and consumption per capita since 1955, Uruguayans continue to fare better than most Latin Americans. The per capita GNP (on a purchasing power parity basis) of about \$750 in 1967 was roughly two-thirds higher than the average for Latin America and ranked Uruguay behind only Argentina and Venezuela in the region; private consumption per capita in Uruguay of some \$575 was second only to that of Argentina. Partly because the major economic activity is ranching, average per capita food consumption amounts to 3,000 calories daily, approximating that in the United States. Moreover, in contrast to almost every other Latin American country, the food intake in Uruguay includes a large component of animal protein. Such indicators of general welfare as rates of literacy and mortality and the incidence of disease also continue to rank Uruguayans among the most favored people in the region. In some of these respects, Uruguay matches the high standards in the United States.

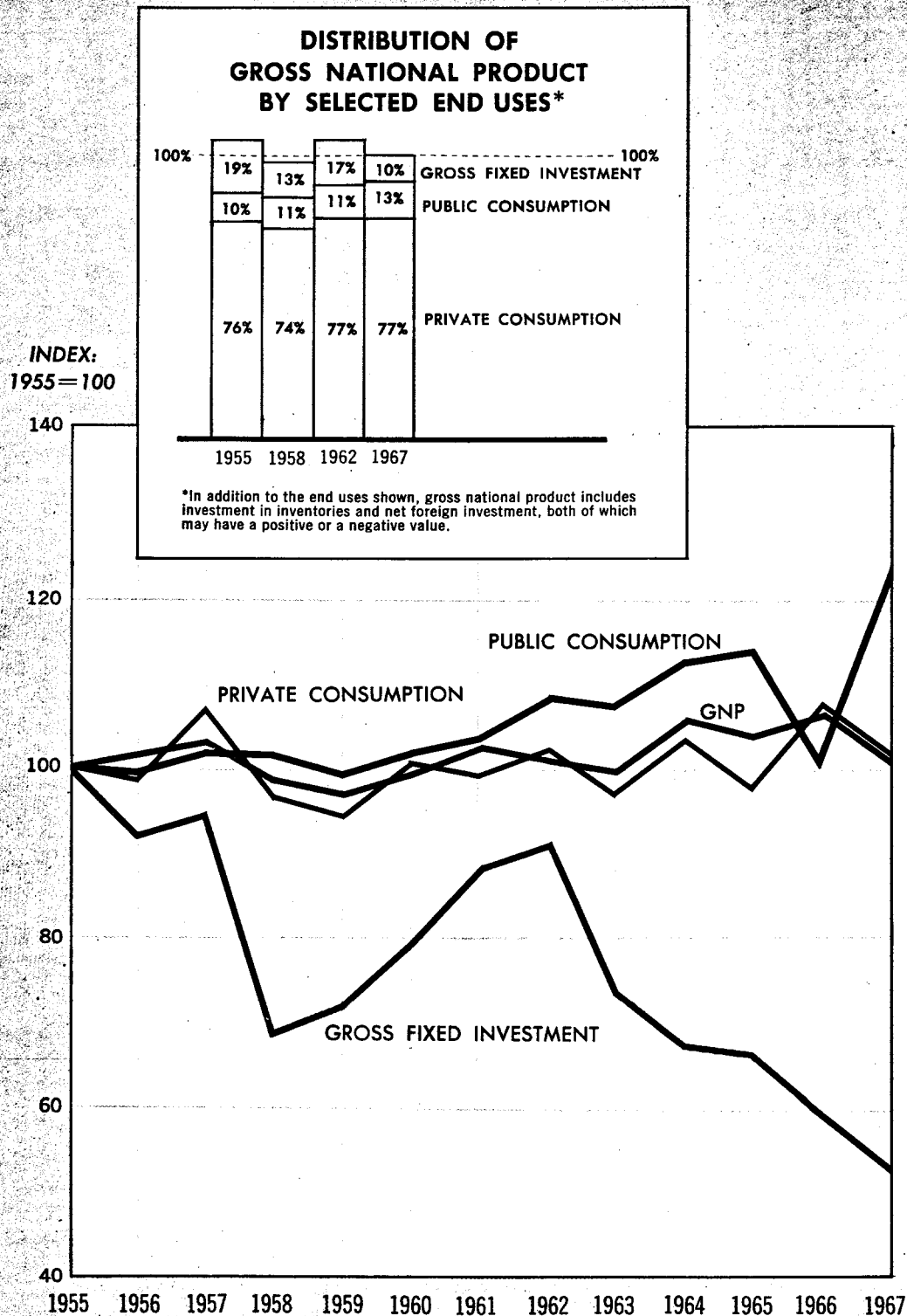
Impact of Reduced Export Prices

7. The economic stagnation that began in the mid-1950's was precipitated by a factor beyond Uruguay's control: a substantial drop in world prices for its main exports. Export prices for wool, meat, and hides, which in 1954 were 35 percent above those of 1948, fell by almost 40 percent from 1954 to 1959 (see Figure 2). These export prices largely recovered in the early 1960's, rising to within 5 percent of the 1948-54 average by 1964, but then fell again in 1965-67, when they averaged 20 percent less than in 1948-54.

~~SECRET~~

Figure 1

URUGUAY: Trends in Gross National Product, Consumption, and Investment, 1955-67

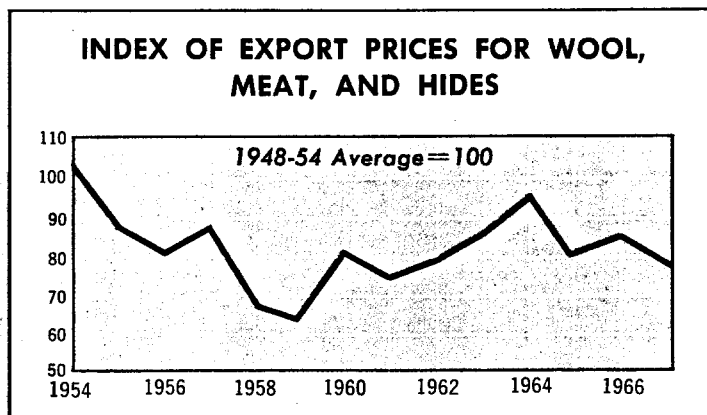
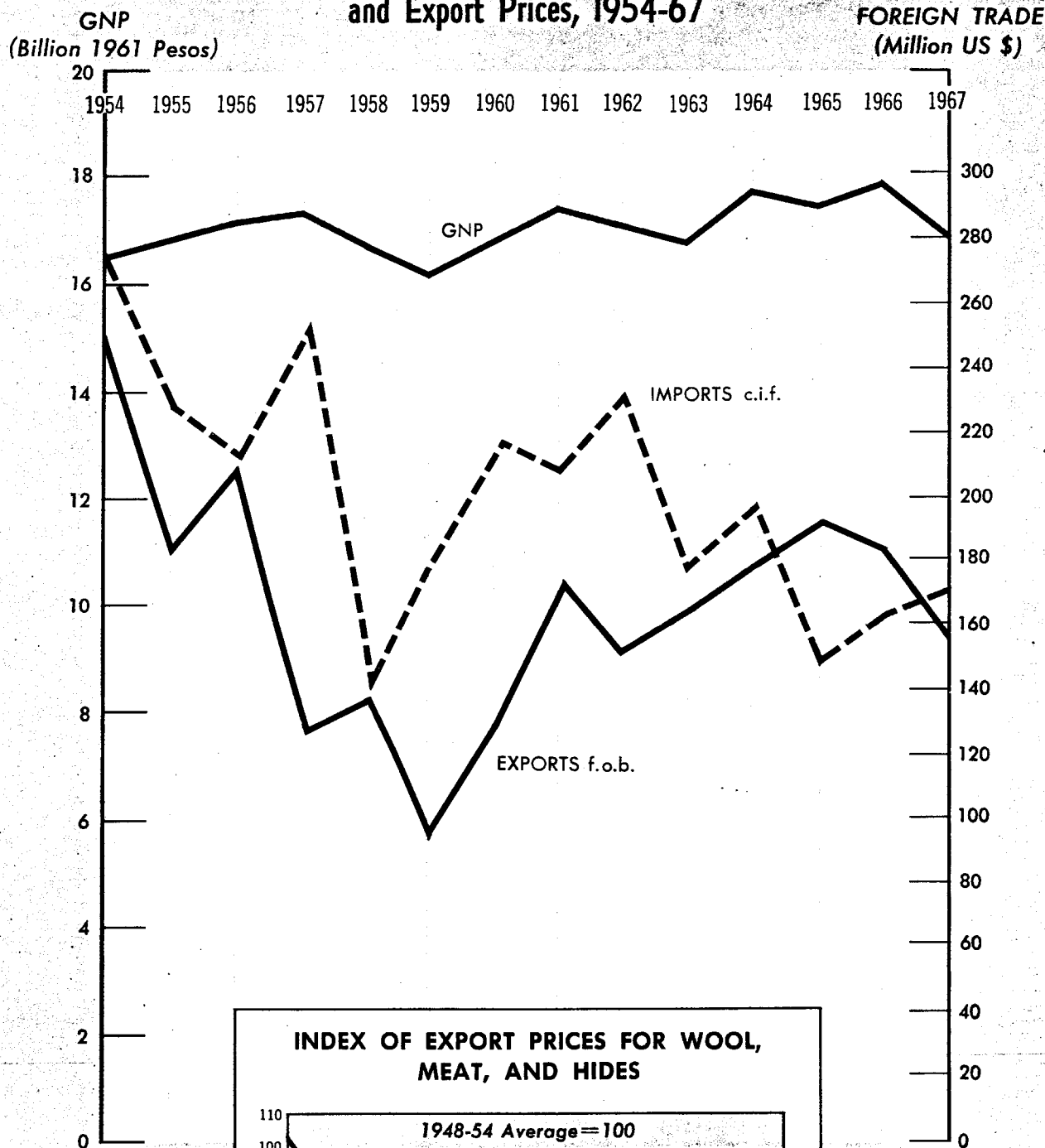


~~SECRET~~

~~SECRET~~

Figure 2

URUGUAY: Trends in Gross National Product, Foreign Trade, and Export Prices, 1954-67



~~SECRET~~

8. Because of reduced prices, the output of stock farming and associated export industries and services -- which accounted for about one-sixth of GNP in the mid-1950's -- fell steadily through 1959. By that time, GNP had been depressed to the level of 1954. Although some output was diverted from domestic consumption to export markets, the volume of major exports tended to fall. This decline in volume and the drop in export prices slashed the value of exports by 60 percent from 1954 to 1959. Although export prices improved subsequently, Uruguay has limped along since 1960 with annual export earnings 25 to 50 percent smaller than those of 1954.

9. The depressive impact of falling world prices on the production and export of livestock products was aggravated by government policies initiated earlier with the aim of achieving self-sufficiency in agriculture. Under the protective umbrella of high export prices, the government had fostered the diversion of pasturage to field crops through the use of price supports in the early 1950's.* Termination of these price supports in 1957 and the acquisition in 1959 of a loan from the International Bank for Reconstruction and Development to modernize the livestock industry contributed to an upsurge in output of livestock products (particularly meat), but output has leveled off since 1964. Price supports for crops were reinstituted in 1962, and the stimulus to investment in the livestock industry arising from improved export prices has been blunted by taxes on export earnings.

10. Although the level of imports fell drastically from 1954 to 1958, Uruguay was able through large-scale borrowing to restore them to more nearly normal levels in the early 1960's, thereby maintaining consumption and investment close to the levels of the mid-1950's. Continued low export levels and growing repayment obligations on foreign

* *Uruguay's occasional attempts to foster self-sufficiency in crops had been generated mainly by strained diplomatic relations with Argentina, the traditional source of wheat imports. The effort in the early 1950's reflected prolonged differences with the Peron regime.*

loans, however, have forced cutbacks in imports since 1962. Most affected by the cutbacks have been imports of capital goods and consumer durables, which provide the bulk of Uruguay's supply of such goods. Imports of industrial materials and components also have declined or leveled off, thereby preventing expansion of output in the industries dependent on such imports.

Obstacles to Economic Readjustment

11. Like Uruguay, various other Latin American countries have suffered a prolonged reduction of export earnings because of weakened prices for their principal exports. And like Uruguay, they have had difficulty adjusting to the situation and have experienced rapid inflation. But none have combined stagnation of output with growing inflation for so long a period. The obstacles to economic readjustment and renovation in Uruguay since 1955 arose mostly from attitudes and institutions developed over many decades, which created rigidities in the structure of production and employment and in the financial system.

Structural Distortions

12. Since the beginning of this century, the Uruguayans have fostered the development of the most urban, egalitarian society in Latin America. Particularly since the 1930's, Uruguayan governments have promoted industrialization and urbanization by emphasizing the development of consumer goods production as a substitute for imports, using high tariffs and tax and credit incentives to this end. Almost all of the enterprises developed by this means have been unable to compete internationally but have at the same time generated new demands for imports of capital goods and raw materials. This is a normal problem of import substitution. But in Uruguay, the resources base is too narrow and the domestic market too small to give producers much opportunity to reduce their reliance on imports. Roughly one-third of Uruguay's manufacturing establishments depend wholly or predominantly on imports for their major raw material input, while the others process mainly domestic agricultural products.

13. The country's commitment to liberal ideas is manifested most clearly in its extensive social security system, which resembles the systems in advanced Western European countries rather than that of the United States. Uruguay's system, which covers nearly everyone and offers generous benefits, provides about 10 percent of the incomes of households, compared with 3 percent in the United States and 10 to 16 percent in Western European countries. Government payments for education and a small consumer subsidy program (which was largely terminated in mid-1967) usually have provided another 3 to 5 percent of the incomes of Uruguayan households. While the system has been able to cover these payments from employer and employee contributions during most of its 60-year history, it has needed support from the government and the banking system in the 1960's.

14. Until recently, at least, the social security system clearly has acted as a major disincentive to work. The fact that Uruguayan men are able, for example, to retire at full pay at age 50 after 30 years of work does much to explain why the proportion of men 45 to 64 years old who are in the labor force is one of the lowest in the world. In recent years the purchasing power of retirement benefits has been eroded by inflation, but the lack of employment opportunities probably has ensured the continued prevalence of early retirement.

15. The strong influence of organized labor, which is not seriously countervailed by that of a "big business" element, has been a further constraint on changes in economic policy. Most of the manufacturing work force and a considerable share of workers in basic services are members of unions. Most unions, in turn, are members of the National Workers' Convention (Convencion Nacional de Trabajadores -- CNT), which on bread-and-butter issues is one of the most militant labor movements in the hemisphere. The CNT leadership, which is dominated by Communists, generally has not been able to politicize the rank and file. But labor nevertheless maintains an unusually strong influence on national economic policy, partly because of the diffused nature of Uruguayan politics. In contrast, the political influence of agricultural interests is very weak, considering the importance of agriculture in the economy.

16. Although some of the weaknesses inherent in the promotion of "hothouse" industries and the extensive social welfare system were apparent in the 1940's and early 1950's, their seriousness was masked by the generally strong world prices for Uruguay's exports that prevailed during those years. Even when the weaknesses were fully exposed by the drop in export prices, successive Uruguayan governments did little to alter the established policies or popular attitudes underlying them. Rather, they consistently turned to two expedients -- increased government spending and foreign borrowing -- that countries commonly use in efforts to live beyond their means, and exercised singularly weak control over the expansion of credit to the private sector.

Financial Distortions

17. Inflation at a steadily accelerating rate is the clearest reflection of Uruguay's failure to adjust to a lower real income. In recent years, inflation has itself become an important cause of distortions in the economy. The annual percentage increase in the cost of living averaged 18 percent during 1956-62 -- not an unusually high figure by Latin American standards. The increase has since grown each year, however, reaching 83 percent in 1967 if average annual cost-of-living levels are compared (see Table 2). The recent acceleration in inflation is shown even more clearly by the price rise of 136 percent from 1 January to 31 December 1967 and the further spurt in prices during the first half of 1968 at an annual rate of 169 percent -- by far the most rapid rates in Latin America in the last decade.

~~SECRET~~

Table 2

Uruguay: Annual Cost-of-Living Increases a/
1956-67

	Percent
1956-62 average	18
1963	21
1964	43
1965	56
1966	74
1967	83

a. Increases are between annual averages of monthly price levels.

18. Surprisingly, the inflation has not yet grown into the runaway variety, under which normal market activities break down. During 1963-66 the increase in prices was roughly proportional to the increase in the money supply (although the supply of quasi-money, such as savings deposits, grew much more slowly). This relationship indicates that the velocity of money did not increase significantly. But for the 12 months ending in September 1967 (the latest period for which data are available), there are indications of an increased velocity of circulation -- a trend that could lead to a severe disruption of economic activity if it continued.

19. Uruguay, unlike most other Latin American countries, has fueled its inflation mainly with an increase in credit to private business. The absence of a central institution possessing the usual powers of a central bank and the apparent unwillingness of the government to apply what monetary controls it had probably are mainly responsible for this excessive credit creation. Uruguay had no central bank as such before 1964 and since that time has vested certain central banking functions in a department of the government-owned Bank of the Republic. These

~~SECRET~~

functions -- which include credit regulation through the fixing of banks' reserve requirements and maximum interest rates as well as the issue of currency -- have been subordinated to the credit expansion activities of the Bank's commercial banking department. The laxity of Uruguayan monetary and credit control is exemplified by the failure of five private banks (including the country's second largest one) in April 1965, which led to heavy withdrawals of foreign exchange from the Bank of the Republic and its default the next month on its foreign exchange obligations. Although the new constitution of 1966 provided for the establishment of a central bank, the bank still was in the process of being organized in early 1968, and central banking functions were divided between it and the Bank of the Republic's department of issue.

20. During 1955-61, virtually all of the net expansion of credit by the banking system was for the private sector. Since 1961, government budget deficits also have been an important source of inflation, inasmuch as government borrowing from the banks has accounted for about one-sixth of the net credit created. But the private sector obviously has remained the dominant factor in credit expansion. In most other Latin American countries, in contrast, the government budget deficits have been the prime sources of credit expansion. Private credit has been more severely rationed in these countries than in Uruguay, and its expansion has been more a consequence than a cause of price increases. Moreover, inflation in these countries was partly a result of growing government expenditures on investment, while in Uruguay such expenditures have been declining.

21. The most important causal factor appears to be the upward push of wages as organized labor tried to protect its standard of living. Wages and prices have chased each other with increasing speed, and private credit has been expanded mainly to finance a stagnant level of production at rising cost and price levels. Private investment has been declining and consequently could not have been an important cause of inflation. Until 1963, exchange rates were kept stable for two or three years at a time while domestic inflation was continuing, but each periodic re-adjustment of the exchange rate further boosted

inflationary pressures. Since 1963, however, devaluations have been frequent, and it has become increasingly difficult to distinguish among the various causes and effects of inflation.

Expediency in Public Finance

22. Uruguayan fiscal policies have fed inflation and diverted funds from productive to nonproductive uses. The government has made heavy use of the public payroll in an attempt to sustain urban standards of living in spite of a declining per capita output. The share of the country's wage bill paid by the central government and the public agencies and enterprises has risen from 30 percent in the mid-1950's to about 40 percent in recent years. Presently, about 20 percent of employment is in the public sector.* About 90 percent of public employees are civilians; the military establishment is small, numbering less than 15,000 persons. Some government employees draw pay for only an hour or two of work each day -- an obvious case of disguised unemployment compensation.

23. Within the central government, the padding of payrolls appears to have been most severe since 1961. Spending for wages rose from 45 percent of current expenditures in 1961 to an average of more than 60 percent in 1964-65 (see Table 3). A constitutional provision prohibiting wage increases in the public sector during the 1966 election year enabled the central government to restrain such payments in that year and to hold the rate of growth of its total current expenditures below that of GNP. But to regain parity with private wage scales (which were not restrained in 1966), the government advanced wages in the public sector by an average

* Time series on the number of public employees and a breakdown of public employment are not available. Data on public finances and judgments by Uruguayan and foreign officials in Montevideo suggest, however, that most people hired by the public sector during the past decade have served no real economic need. The railways, port authority, and government financial institutions frequently are cited as major sources of make-work employment.

~~SECRET~~

Table 3

Uruguay: Central Government Finances a/
1961-67

	<u>1961</u>	<u>1962</u>	<u>1963</u>	<u>1964</u>	<u>1965</u>	<u>1966</u>	<u>1967</u> Estimated
	Billion Pesos						
Revenues	2.73	2.69	3.21	4.58	6.46	13.31	19.50
Expenditures b/	2.71	3.13	3.47	4.76	8.30	13.84	24.50
Current expenditures	2.61	2.98	3.33	4.59	8.08	13.19	21.60
Wages	1.18	1.43	1.78	2.76	5.11	7.40	13.70
Subsidies	0.86	0.95	0.95	1.08	1.59	2.81	7.90
Other	0.56	0.60	0.60	0.76	1.38	2.97	
Investment expenditures	0.10	0.15	0.14	0.17	0.22	0.65	2.90
Surplus or deficit (-)	0.03	-0.44	-0.26	-0.18	-1.84	-0.52	-5.00
Financing of the deficit							
Net credit from Bank of the Republic	0.06	0.30	0.33	0.26	1.83	0.62	4.50
Other sources	-0.09	0.14	-0.07	-0.08	0.02	-0.10	0.50
	Percent of Gross National Product						
Revenues	15.8	14.3	14.3	13.7	12.2	13.1	10.7
Expenditures	15.6	16.6	15.4	14.3	15.6	13.7	13.4

a. Because of rounding, components may not add to the totals shown.

b. The distribution of expenditures is estimated from budgetary authorizations.

~~SECRET~~

of 90 percent at the beginning of 1967. As a consequence, wages in 1967 again reached some 60 percent of current expenditures.

24. Government transfer payments to households and subsidies to municipalities and public enterprises also rose in absolute terms but declined as a share of total expenditures. During 1961-66 the enterprises failed each year to cover even their current operating expenses with sales revenues (see Table 4). The State Railroad Administration, National Petroleum and Cement Corporation, State Waterworks, and State Airlines are the major sources of deficits among the enterprises. Large payrolls, low pricing for services, and (in the case of the railways) strong competition from road transport all contribute to the deficits. Contributions to the social security funds, which potentially are an important source of savings in a country with a weak capital market, failed to cover operating expenses and pension payments in 1962, 1964, and 1966. Data are not available for the financial performance of the public enterprises and social security funds in 1967, but the weaknesses of the preceding five years probably continued. The deficits of public enterprises and the social security funds have been financed mainly by subsidies from the central government and large credit extensions from the Bank of the Republic.

25. While swelling its payroll, the central government cut its investment expenditures drastically during 1955-61 and held them at 3 to 5 percent of its total expenditures during 1962-66. The bulk of such investment normally has been in basic services such as electric power, transportation, and communications. Depreciation of such facilities almost certainly has exceeded new investment in most years since the mid-1950's. The effects of reduced public investment have been severe in agricultural areas, where transportation and communications facilities frequently are reported to be in disrepair. Failure to invest in irrigation facilities aggravated the harmful effects of drought and floods in 1959, 1960, 1964, and 1967.

~~SECRET~~

Table 4

Uruguay: Finances of Public Enterprises
and Social Security Funds a/
1961-66

	Billion Pesos					
	<u>1961</u>	<u>1962</u>	<u>1963</u>	<u>1964</u>	<u>1965</u>	<u>1966</u>
Public enterprises						
Revenues	1.67	2.15	2.45	3.65	5.77	7.94
Current expenditures	1.70	2.30	2.97	4.05	6.77	8.31
Investment expenditures	0.12	0.14	0.17	0.16	0.42	0.77
Surplus or deficit (-)	-0.16	-0.29	-0.69	-0.56	-1.41	-1.14
Social security funds						
Contributions	1.58	1.93	2.39	3.17	5.78	9.25
Operating expenditures	0.40	0.49	0.56	0.83	1.29	2.27
Pension payments	1.17	1.54	1.82	2.75	4.31	7.40
Surplus or deficit (-)	0.01	-0.10	0.01	-0.41	0.19	-0.42

a. Because of rounding, components may not add to the totals shown.

26. Cutbacks in public investment and the relatively slow growth of subsidies permitted the government to fatten its payroll without incurring major budget deficits during 1955-61, but large budget deficits have been recorded consistently since 1961 (see Table 3). The deficits were particularly large in 1965 and 1967, when they equaled 3.5 and 2.7 percent of GNP. Although the share of government expenditures in GNP has tended to decline in recent years,* large deficits have occurred because the share

** This is true of government expenditures inclusive of subsidies and investments. As indicated in Figure 1, public consumption of goods and services has risen as a share of GNP.*

~~SECRET~~

of revenues in GNP has declined even more. By 1965, revenues in real terms had fallen about 22 percent below their 1961 level, mainly because of the erosive effects of inflation under a poor system of tax collection. Revenues recovered to almost 87 percent of the 1961 level in 1966 as a result of new taxes (some imposed as an emergency measure for only one year), a sharp jump in receipts from export taxes (which were raised to capture windfall profits arising from devaluation), and increased tax receipts from imports. In 1967, however, real revenues again dropped, mainly because of increased laxness in tax administration in the face of rapid inflation and because of the fall in exports and in export tax rates.

Resort to Foreign Borrowing and Exchange Control

27. In an effort to maintain imports of essential raw materials and capital goods in spite of the sharp drop in exports from 1954 to 1959, Uruguay initially drew down a large share of its foreign exchange reserves of \$335 million. Reserves fell to about \$200 million in 1957 and have since ranged around that amount. About half of these reserves are committed as collateral against foreign loans and do not represent a liquid foreign exchange source available to support deficits in international payments. Foreign lenders also provided a major prop to imports in 1955-62, supplying an average of \$43 million yearly in net foreign exchange inflows. By 1962, however, Uruguay's credit standing abroad was very weak, and it subsequently was forced to bring its imports more into line with its reduced export capacity.

28. The downward trend in imports, slow recovery of export earnings, and growth of tourist receipts brought Uruguay's current account into balance and even generated some surpluses during 1963-67 (see Table 5). But the overall balance of payments continued in deficit through 1965, mainly because of the flight of savings from the country.* The amounts for net errors and omissions in the balance of payments

* *This situation contrasted sharply with the late 1940's and early 1950's, when Montevideo was a haven for flight capital from other Latin American countries.*

~~SECRET~~

suggest that capital flight was particularly severe in 1964-65, when it may have equaled as much as half of gross fixed investment. The large payments deficits in 1964-65 were funded mostly through the accumulation of commercial arrears, which at the end of 1965 amounted to more than \$155 million. Payments surpluses achieved in 1966-67 in turn were used mainly to reduce the commercial arrears to approximately \$110 million at the end of 1967.

Table 5

Uruguay: Balance of Payments
1963-67

	Million US \$				
	<u>1963</u>	<u>1964</u>	<u>1965</u>	<u>1966</u>	<u>1967</u> <u>Estimated</u>
Current account balance	<u>-0.7</u>	<u>-0.8</u>	<u>72.0</u>	<u>43.7</u>	<u>0</u>
Trade balance (c.i.f.)	-3.3	-8.2	54.7	30.1	-15.0
Tourism	9.9	15.0	26.0	22.0	29.0
Other services (net)	-7.3	-7.6	-8.7	-8.4	-14.0
Net receipts of capital	<u>-9.7</u>	<u>-11.2</u>	<u>-12.8</u>	<u>5.7</u>	<u>23.0</u>
Private sector	-10.8	-10.9	-13.7	5.0	20.0
Long-term	-0.1	-0.7	-0.5	0	0
Short-term	-14.8	-12.4	0.4	4.0	21.0
Suppliers credits	4.1	2.2	-13.6	1.0	-1.0
Public sector	1.1	-0.3	0.9	0.7	3.0
Net errors and omissions	<u>0</u>	<u>-69.9</u>	<u>-92.4</u>	<u>-13.6</u>	<u>13.8</u>
Balance of payments surplus or deficit (-)	<u>-10.4</u>	<u>-81.9</u>	<u>-33.2</u>	<u>35.8</u>	<u>36.8</u>
Net increase (-) or decrease in net foreign reserves	<u>10.4</u>	<u>81.9</u>	<u>33.2</u>	<u>-35.8</u>	<u>-36.8</u>

29. The long-term obligations abroad of the central government and public institutions amounted to \$115 million at the close of 1967. Servicing obligations on this sum amount to \$17 million for 1968, or about 12 percent of anticipated export earnings. This ratio is not high by Latin American standards because public investment in the last decade has been small. But payments for commercial arrears and other short-term obligations are expected to raise total debt payments for 1968 to about \$75 million, or a little more than half of probable export earnings.

30. Uruguay's always pressing and sometimes critical international finances have prompted the development of an extensive system of exchange and trade controls, including multiple exchange rates, registration of foreign exchange transactions, and prior deposits for imports. During most of the last 12 years, the government has been slow to devalue the Uruguayan peso in response to rapidly rising domestic prices. This reluctance, together with weak administration of direct exchange controls to protect foreign reserves, has caused the government to place particular reliance on import controls. Occasionally, it has temporarily embargoed almost all imports. Since mid-1965, however, Uruguayan governments have adjusted the exchange rate more frequently to reflect inflation. From that time through August 1967, there were six devaluations that changed the rate for most transactions from 24 to 99 pesos per US dollar. Further devaluation changed the principal rate to 200 pesos per dollar at the end of November 1967 and to 250 pesos per dollar in April 1968.

Some Repercussions of Stagnation and Inflation

31. Although Uruguayans have been protected to some extent from the effects of economic stagnation by the government's attempts to maintain standards of living, there has been an erosion of confidence in the future of the country. Investment activity in the last two or three years has been following the pattern commonly associated with rapid inflation -- speculative stockpiling and short-term capital flight in anticipation of devaluation, and increased investment in real estate. Even more

~~SECRET~~

serious, a sizable share of the flight capital apparently does not return after devaluation. Uruguay also seems to be suffering a loss of technical and entrepreneurial talent. Loss of confidence likewise is reflected in the increasing (although still limited) politicization of labor along radical lines and in the dominance of student protest movements by leftists. Finally, concern over the country's future has been expressed by some elements of the traditionally apolitical Uruguayan military, which before Pacheco Areco assumed office clearly were disturbed by the inability of the government to face up to its problems.

32. The country's problems also have shaken the populace into accepting the need for some action within the constitutional framework. In 1952, Uruguay's executive was constituted as a nine-man National Council of Government. This form of government proved utterly incapable of providing effective leadership, and the Uruguayans consequently restored a single executive by plebiscite on a new constitution in late 1966. The change was approved despite the knowledge of the electorate that such action would provide the institutional basis for a more rigorous application of reform. Political power in the legislature, however, remains badly fragmented, which makes it very difficult to obtain support for an unpopular economic program.

Current Financial Stabilization Program

33. For some years, Uruguayan leaders have been aware of most of the implications of the country's economic problems, and since late 1965 they have made some attempts at financial stabilization. While these efforts have slightly improved the country's balance-of-payments position, they have on the whole failed to ease domestic financial difficulties or lay the basis for sustained economic growth. Stabilization programs have foundered on the government's reluctance to clamp down on wage increases for public employees and on its inability to control wages and credit in the private sector. Money wages almost doubled in the private sector during 1966 and in the public sector in early 1967.

~~SECRET~~

34. The latest stabilization effort was initiated in November 1967, when the currency was devalued from 99 to 200 pesos per US dollar. The plan envisaged a sharp reduction in the rate of price increase and a moderate improvement in foreign reserves. The government judged that achievement of these goals would depend on its holding the budget deficit in 1968 to about 7 percent of expenditures (compared with 20 percent in 1967) and on applying more stringent controls over the growth of credit for the private sector. The budget deficit was to be reduced by holding wage increases to an average of 60 percent above the 1967 level. Limitations on expansion of credit depended largely on the expectation that the recently formed central bank would be able to exercise more effective control over bank lending by means of increased reserve requirements and ceilings on credit. Improved domestic financial performance, more frequent adjustments of the exchange rate to reflect the continuing inflation, and substantially increased receipts of long-term development assistance were supposed to permit a gain of \$30 million in foreign exchange reserves. This improvement was expected despite an anticipated second consecutive year of poor export performance.

35. The fragmentary evidence now available on Uruguay's financial performance under the new stabilization program indicates mixed results. The cost of living increased about 64 percent in the first six months of 1968, or more than during the same period in 1967. This increase partly reflects the impact on domestic prices of the large devaluation in November 1967 and the continuing impact on prices of the poor harvest in 1967. The continuing rapid increase in prices also reflected the government's tenuous influence over wages. Major wage settlements in the public sector during the first months of 1968 provided an average increase of about 90 percent, or considerably more than the targeted level.

36. The administration of President Pacheco Areco nevertheless has shown more resolve in economic affairs than any of its predecessors in the last dozen years. Wage settlements in the public sector fell far short of those demanded by labor, and workers' dissatisfaction with those settlements and

the generally hard-nosed attitude of the government is a major cause of the current political unrest. The government declared a limited state of siege in early June and decreed a price and wage freeze in late June that apparently is being stringently enforced. It also has submitted a bill to the Congress that provides legislative sanction for government control over union activities and price and wage increases in the private sector. Acting on its commitment to maintain a realistic exchange rate, the government further devalued the peso to 250 per US dollar in April. This move, together with the renegotiation in June of \$50 million in debts to private foreign lenders and a 30-percent reduction in imports in the first six months of 1968, contributed to a small improvement in foreign exchange reserves. Export earnings declined in the first six months, but at a slower rate than imports.

Prospects

37. For the next year, continuing economic stagnation and rapid inflation appear to be in prospect. The situation could improve slightly or deteriorate slightly, depending on three circumstances beyond Uruguayan control: crop conditions, world market conditions for exports of livestock products, and the generosity of foreign lenders. It also could deteriorate greatly if the government puts the brakes on the economy too forcefully, if active popular resistance becomes widespread, or if the government is forced to abandon its stabilization program.

38. Although there are a few hopeful signs for the economy in the next 12 months, Uruguay is now too much a prisoner of its past mistakes to make important gains in so short a period. Preliminary reports indicate a favorable turn in the weather since midyear; devaluation has reduced pressure somewhat on the balance of payments; and the government is at least trying to hold down wage and price increases. Other circumstances, however, do not favor progress in financial stabilization and the expansion of output. Political pressures for wage and price increases remain very strong. Demand pressures built up by recent large wage increases

in the public sector will be hanging over the economy. Added pressure on prices will arise if the government pursues its policy of frequently devaluing the currency as domestic prices rise. Livestock output probably will drop because of losses to herds in the drought of 1967. This decline and an anticipated squeeze on imports of industrial materials probably will depress industrial production. Private investment almost certainly will remain small because of the political and financial uncertainty, and the government can scarcely boost public investment while trying to cut its deficit sharply.

39. The government also runs a serious risk of inducing events that would disrupt output. If it abandoned its stabilization program for political reasons, disruption might be brought about by runaway inflation. Rates of inflation much in excess of the increase of 136 percent during 1967 are likely to accelerate the rate of turnover of money, which (if unchecked) could lead to widespread use of barter and a diversion of labor from productive activity. On the other hand, the government is confronted with an intense popular discontent that could prompt further general strikes and even erupt into violence. Maintenance of the stabilization program would heighten the risk of widespread civil disorder and consequent economic deterioration. The risk of public disorder would be still greater if the government initiated policies of the sort that might eventually solve the country's fundamental economic problems. And if the government took drastic deflationary measures, production probably would decline sharply and unemployment would rise.

40. Uruguay's economic prospects for the long term depend heavily on the political strength as well as the economic policies of the government and thus are highly uncertain. Although differing in some respects, Uruguay's economic problems generally resemble those of Argentina, and a similar long-term program of basic economic reform is called for. A lengthy period of inadequate investment expenditures in agriculture has caused some net disinvestment in the sector, including a decrease in cattle numbers. Uruguay's rich pastureland -- its major natural resource -- consequently is

~~SECRET~~

underutilized at present. Most of the industrial capacity likewise is underutilized because of insufficient inputs from agriculture and constraints on imports of industrial materials. Industry is capable of processing an increased volume of agricultural products for export and domestic consumption and of more adequately meeting demand for non-agricultural products. To a large extent, this underemployment of resources constitutes a potential source of strength for growth over the long term. But realization of this potential depends on the restoration of financial stability and increased investment. A substantial increase in total investment and greater concentration of it in agriculture eventually would permit renewed growth in exports and relaxation of import constraints, would slow down the pace of inflation, and would permit a rise in productivity and real income.

41. Achievement of these goals faces enormous barriers, for the task of economic reform seems to be even more formidable in Uruguay than in Argentina. Uruguay's small size and narrow economic base are handicaps and result in high costs in most Uruguayan industries other than agricultural processing. Exports of nonagricultural manufactures averaged only \$8 million annually in 1962-66, or 5 percent of total exports. Other barriers are the long attunement of consumers and businessmen to rapid inflation, the weakness of government institutions, and the country's poor credit standing abroad.

42. The greatest obstacle of all, however, probably is the attitude of the people. Economic reform implies a sustained period of austerity that would have to be borne mainly by the urban population, which makes up most of the total. Having suffered a decline in their living standards during the past 12 years, the Uruguayans will hardly welcome the news that an extended period of economic sacrifice is called for. Since urban labor is effectively organized, it can be expected to resist sacrifice. Financial and business leaders, some of whose operations are hopelessly inefficient and should be scrapped or allowed to wither, also are likely to find a shift in policy emphasis to

~~SECRET~~

~~SECRET~~

agriculture unpalatable. Under these circumstances, it is questionable whether Uruguay can move toward the solution of its fundamental economic problems without a government that is willing and able to pursue policies opposed by a majority of the people.

~~SECRET~~